A reexamination of agency theory assumptions: extensions and extrapolations

Peter Wright\textsuperscript{a}, Ananda Mukherji\textsuperscript{b,}\textsuperscript{*}, Mark J. Kroll\textsuperscript{c}

\textsuperscript{a}Fogelman College of Business and Economics, The University of Memphis, Memphis, TN 38152, USA
\textsuperscript{b}Department of Management and Marketing, Texas A \& M International University, Laredo, TX 78041-1900, USA
\textsuperscript{c}Department of Management and Marketing, College of Administration and Business, Louisiana Tech University, Ruston, LA 71272, USA

Abstract

In this paper, we discuss agency theory in the context of the individual principal and agent, and also in the context of the organization and its groups. Agency theory is examined in the context of goal orientation, obligation and reciprocity, risk, and self-interest. We offer propositions given agency theory's assumptions. We also extend agency theory and offer alternative propositions based on relaxing of agency theory's assumptions. In relaxing the assumptions of agency theory, insights from outside the agency literature, specifically from behavioral theories are used. Implications of agency theory and the extension of this theory are also discussed in relation to outcomes associated with economic exchanges. © 2001 Elsevier Science Inc. All rights reserved.

1. Introduction

Agency theory deals with the cooperative relationship which develops when one individual in an economic exchange (the principal) grants authority to another (the agent) to act on his or her behalf, and the welfare of the principal becomes affected by the decisions of the agent (Arrow, 1985; Barney \& Ouchi, 1986; Jensen \& Meckling, 1976). The concern of this theory is that the welfare of the principal may not be maximized because the principal and the agent tend to have different goals as well as differing predispositions toward risk (Wright, Ferris, Sarin \& Awasthi, 1996). Specifically, principals are considered risk neutral in their

\textsuperscript{*} Corresponding author. Tel.: +1-956-326-2526.

E-mail addresses: max@tau (A. Mukherji), pwright@latte.memphis.edu (P. Wright).
preferences for individual firm actions since principals can diversify their shareholdings across multiple firms (Wiseman & Gomez-Mejia, 1998). In contrast, agents are assumed to be risk averse since agent employment security and income are inextricably tied to a single firm (Donaldson, 1961; Williamson, 1963). In essence, agents are assumed to be risk averse in decisions regarding the firm in order to lower risk to personal wealth. Thus, the focus of agency theory is on a contract that minimizes costs associated with an agency relationship.

Agency theory is rooted in economic utilitarianism (Ross, 1973). By narrowly focusing on the principal-agent relationship, and with a given set of assumptions, the contribution of this theory is that it provides logical predictions about what rational individuals may do if placed in such a relationship. Moreover, the agency relationship is conceived in the context of a single principal or agent. This is beholden to the social science doctrine of methodological individualism (Donaldson, 1990). The contention of this doctrine is that economic phenomena should be examined from the view of deliberate behavior of individuals since economic life can best be understood as maximizing behavior on the part of all individuals. In this setting, the agency problem becomes more evident—if both the agent and the principal are utility maximizers, because the presumption is that the agent will not act in the best interests of the principal (Jensen & Meckling, 1976).

Agency theory has been criticized for being too narrow because this theory emphasizes the contract between a principal and an agent, and the ways in which the contract can be made more efficient from the perspective of the principal (Eisenhardt, 1989; Perrow, 1986). We contend that this theory may also be too narrow because its assumptions discount contingencies that may be more reflective of realities in economic relationships. That is, the restrictive assumptions of agency theory discount the possibility that diverse individuals in various situations may behave differently. Consequently, in this paper we are concerned with extending agency theory by relaxing some of its assumptions. In our view, the extension of this theory may allow for a more balanced assessment of agency relationships as economic exchanges, not only between two individuals but also in the context of the group and organization. Thus, in this paper we provide a broader perspective on agency theory.

While examining the principal-agent relationship, we closely study the classical components of agency theory of goal orientation, obligation and reciprocation, risk, and self-interest (see Fig. 1). Agency theory centers around the rigid assumptions made about these components. However, the same components are reexamined for outcomes after relaxing agency
theory assumptions. Our work is organized into several sections. We first survey and review the literature that is associated with agency theory as it is understood in the economics paradigm. This is followed by examining competing paradigms that become the basis for extending and extrapolating agency theory. The competing paradigms are from the management and behavioral viewpoints. Following a presentation of the competing paradigms, we discuss agency theory and its extension by focusing on the individual in agency relationships. We also elaborate on agency theory and its extension by also focusing on the group and organization. Subsequently, we develop alternative propositions—some based on the assumptions of agency theory and others based on relaxing those assumptions. Finally, we offer our concluding remarks, including our assessment of public policy implications.

2. State of the art in economics and management

2.1. The economics and management paradigms

There are two fundamental and differing approaches in analyzing and understanding behavior. In this paper, we address both perspectives not necessarily with a view to reconciling them, but to present to the readers that an appreciation of both views is important in order to have a more complete understanding of reality. In commenting on the two contrasting perspectives, March (1994), in an insightful essay on decision making, discusses the two broad schools of theorists. One is the school of formal theorists, representing the economics paradigm, where the focus is on making rational choices toward maximization of utility. The other is the behavioral school of decision making, representing the management paradigm.

2.1.1. The economics perspective

It is important to note that agency theory is built on a number of explicit (and critical) assumptions about the behavior of agents. Agency theorists, with regard to assumptions made about agents, specifically refer to the problem of opportunism. Opportunism is perceived as self-interest seeking with guile (Arrow, 1971; Williamson, 1975). Thus, the expectation is that economic actors may disguise, mislead, distort, or cheat as they partner in an exchange. In spite of provision of incentives and monitoring, it is anticipated that opportunism may prevail because of adverse selection or moral hazard.

A review of current research will indicate the importance scholars continue to pay to the efficacy of contracts, incentives, and appropriate monitoring systems for agents. The impact of efficient contracts that can be used to align the behaviors and actions of agents has recently been studied, among others, by Guth, Klose, Konigstein and Schwalbach (1998), Mukerji (1998), Indjejikian and Nanda (1999), and Jambulingam and Nevin (1999). Similarly, the designing of appropriate incentive and compensation systems in order to ensure that agents have the principals' interests in mind have been researched by Chakraborty, Kazarosian and Trahan (1999), Denski, Sappington and David (1999), Kraft and Niedprum (1999), Newman and Mozes (1999), and Pendergast (1999), Bartol (1999) and Vaees (1999) have studied systems, frameworks, and mechanisms to monitor agents. Each of these groups of
researchers has examined different aspects of agency problems in a continued effort to develop and refine contracts, incentives, and monitoring systems for agents.

In addition, agency theory also assumes a risk-averse agent, and expects agents to exhibit risk averse behaviors in decision making. However, and based on the approach of formal theorists used in the economics paradigm, deviations from this assumption of being risk averse are considered to be abnormalities and distortions that are exceptions rather than the norm. When faced with distortions on the maximization of expected utility, agency researchers consider such nonrisk averse preferences (where agents are risk seeking or risk loving) as either special cases of agent behavior (Jensen & Meckling, 1976) or simply uninteresting (Arrow, 1971).

In summary, the economics paradigm has a set of negative assumptions regarding individuals and their behaviors. The focus of economics research, given the assumptions, is to examine the efficacy of contracts so as to manage agents efficiently, and to also examine incentives that align the behavior of agents with those of principals. As Fama and Jensen mention, “contracts or internal rules of the game specify the rights of each agent in the organization, performance criteria on which agents are evaluated, and the payoff functions they face. The contract structure combines with available production technologies and external legal constraints to determine the cost function for delivering an output with a particular form of organization” (1983, p. 302). As this section indicates, and based on the work of researchers, there is considerable theoretical and empirical support for the economics paradigm. Deviations from normative expectations are explained as aberrations, which can be addressed through improved contracts, incentives and monitoring.

2.1.2. The management perspective

Both the economics and the management perspectives give considerable autonomy and freedom to agents. Recall that in the economics paradigm, the assumption is that agents will invariably use this autonomy to enrich themselves at the cost of the principal. Using a structuration perspective and providing an explanation of agent autonomy, Giddens states, however, that “the conduct of actors in society is treated as the outcome of a conjunction of social and psychological determinants, in which the former dominate the latter through the key influence attributed to normative elements” (1983, p. 52). Giddens (1983) gives considerable power of reflexivity and control to the agent who is able to monitor, rationalize, and motivate his or her actions based on assessing unacknowledged conditions of action, and unintended consequences of action. Giddens (1983), thus, focuses on noneconomic predispositions of the agent.

Moreover, in the management paradigm, agent autonomy is not necessarily used negatively but that the autonomy has and can be used for numerous positive possibilities. The stakeholder theory of the firm in management literature (Donaldson & Preston, 1995; Jones, 1995; Quinn & Jones, 1995) beneficial aspects to agent autonomy are presumed. Under the stakeholder viewpoint agents, in many cases, operate with moral and ethical considerations. In addition to the stakeholder perspective, management research has developed an impressive body of literature that has grown independent from the classical assumptions in economics regarding agency theory (see an earlier section, and also Wiseman and Gomez-Mejia, 1998 for a review). This body of research has not only challenged the restrictive
assumptions of agency-based models of formal theorists, but has provided compelling
evidence to incorporate a broader, more holistic approach in understanding principal-agent
relationships. Much of this research provides compelling theoretical and empirical support
for incorporating a positive behavioral perspective in understanding interpersonal relations-
ships.

In summary, it is suggested that agency issues may be very complex, and to examine them
from a very restricted set of assumptions may provide not only an incomplete but also an
inaccurate view of interpersonal relationships. A large body of theoretical and empirical
evidence does indicate that the view of the formal theorists in economics may be too
restrictive, and a broadening of the agency phenomenon using a behavioral perspective
would be useful. The management perspective is interested in the “deviations,” and considers
the study of these “deviations” to be central to behavioral research. Thus, apart from the
stakeholder view, the work of numerous behavioral researchers examining managerial
decision making processes (Bowman, 1980; Bromiley, 1991; Fiegenbaum, 1990; Jegers,
1991; March & Shapira, 1987; Sinha, 1994; Tversky & Kahneman, 1981) testifies to the
theoretical and empirical support for the management or behavioral perspective.

3. Focus on the individual

Agency theory focuses on the relationship between the individual principal and the agent,
as it examines economic exchanges between them. Strict adherence to its assumptions, on
which we will further elaborate, we predict will lead to suboptimal outcomes. That is because
agency issues and, consequently, agency costs cannot be completely eliminated, according to
this theory, unless the role of the principal and the agent are combined into one (i.e., in the
case of an individual who owns one hundred percentage of the enterprise). In the ensuing
pages, we will examine agency theory and its assumptions—that principals and agents have
different goal orientations as well as risk preferences. Additionally, we will extend this
theory by relaxing these assumptions. Alternative propositions will subsequently be offered
according to the premise of agency theory as well as according to an extended view of
agency relationships.

3.1. Goal orientation

At the individual level, as we will discuss in this section, one extension that may be made
regarding agency theory is to relax the assumption of goal conflict between the principal and
the agent. We shall remember that, per agency theory, the principal (owner) derives financial
benefits or costs from an agency relationship. The agent, however, derives not only pecuniary
but also nonpecuniary benefits (or costs) from this relationship. In this view, “the nonfinan-
cial rewards (or costs) are subject to consumption only by the insider [agent], with share-
holder [principal] consumption not possible” (Wright et al., 1996, p. 447). The nonfinancial
benefits may include “the physical appointments of the office, the attractiveness of the
secretarial staff, the level of employee discipline . . . and so forth” (Jensen & Meckling,
1976, p. 486). The nonfinancial costs relevant to the agent may encompass the additional
effort required to search for new profitable ventures, or understand new technologies, or alternatively the anxieties inherent in the adoption of various innovations. Note that goal conflict is assumed between the principal and the agent because in this setting different utility functions exist; consequently, the agent’s decisions are expected to be costly for the principal (Jensen & Meckling, 1976).

We speculate, however, that individual agents may have diverse orientations, as they relate to nonfinancial benefits versus costs in their specific place of employment. For instance, some agents not only may consume perquisites but may also be work-averse. These agents are not likely to perform responsibly on their particular jobs, consistent with the arguments of agency theory (Jensen & Meckling, 1976). For these agents, shirking may be especially preferred because in this way they can lower their disutility associated with the efforts invested in their specific work. Recall that shirking is the most important source of agency conflict (Jensen & Meckling, 1976, p. 487). Under these circumstances, the assumption of goal conflict may be appropriate, since shirking on the part of the agent is particularly detrimental to the interests of the principal. Such a possibility is compatible with the notion that some individuals in select exchanges tend to transmit negative sanctions to others (Willer, 1981). The assumption of goal conflict, however, may be relaxed in other situations that involve yet other types of agents. That is, it is possible that in a different situation other types of agents may alternatively enjoy performing responsibly because of their personal need for achievement (McClelland, 1960). These other agents may not mind exerting extra effort in their work because the utility associated with their sense of achievement on their particular jobs may dominate the disutility associated with the corresponding effort expended. Moreover, these agents may not excessively consume perquisites in their employment. Here, we are merely pointing to situations where agency theory’s rigid assumptions may be relaxed (or consider less relevant) due to situational and/or dispositional factors. Under these circumstances, the well accepted assumptions of goal conflict may become moot.

The assumption of goal conflict may, however, also be valid for some agents who in certain settings may not derive utility from receiving love or respect from the principal for a job well done, consistent with the premise of agency theory (Jensen & Meckling, 1976). Emphasis should be made that the existence of “love” or “respect” as potential nonpecuniary benefits are recognized in this theory (Jensen & Meckling, 1976, p. 486) but not in the context of the owner (principal)-manager (agent) relationship. In a different setting involving other agents, however, the assumption of goal conflict may be relaxed. That is, other agents in a different situation may derive satisfaction from receiving love or respect from the principal in response to their high performance.

Our contention is compatible with Maslow’s (1943) theory of human motivation. Accordingly, individuals tend to have needs for love and respect—“love needs involve both giving and receiving love . . . [and esteem needs involve] self-respect . . . and for the esteem of others” (Maslow, 1943, p. 381). Furthermore, the assumption of goal conflict similarly may be relaxed if for some agents high performance on their specific jobs satisfies their need for self-actualization (McClelland, 1960). Note that if for an agent self-fulfillment is “the desire to become everything that one is capable of becoming” (Maslow, 1943, p. 382) at work, responsible job performance and promotion of the principal’s interests may be the
anticipated outcomes. The relaxing of the assumption of goal conflict under these circumstances is consistent with the contention that some individuals in select exchanges are motivated to transmit positive sanctions to others (Willer, 1981).

Additionally, implicit in the agency relationship is the notion that costs and benefits not only accrue in the context of the relationship between the principal and the agent—as the agent consumes perquisites at the expense of the principal—but also in the context of the agent’s relationships with others. More specifically, the agent is recognized to derive nonpecuniary benefits from a set of other relationships but the pecuniary costs incurred as a result of these relationships are presumed to be channeled back to the principal. In this setting, the agent in pursuit of nonpecuniary benefits in her relationship with others (e.g., in order to receive love, respect, or admiration from others) contributes to their well being. According to agency theory, acts which promote the well being of others may include “the kind and amount of charitable contributions, . . . relations (‘love’, ‘respect’, etc.) with employees, . . . purchase of production inputs from friends, and so forth” (Jensen & Meckling, 1976, p. 486). We emphasize, however, that although the preceding acts benefit the agent as well as the community, employees, or suppliers, they are considered to be detrimental to the interests of the principal. Under these circumstances, the assumption of goal conflict may be appropriate presumably because, in these situations, there may be an absence of predispositions of obligation and reciprocity vis-a-vis the principal.

Alternatively, in certain other situations, the assumption of goal conflict may be relaxed. In these other situations, it may be argued that the agent’s pursuit of nonpecuniary benefits, advancing her own interests as well as the interests of others, could also be advantageous to the principal. The reason is that, as the agent benefits others, they may become indebted, as exchanges are often based on the social norms of obligation and reciprocity (Fukuyama, 1995). Here, the aggregate goodwill generated in the context of the socially embedded enterprise (Granovetter, 1985) may boost its future prospects, also enhancing the value of the principal’s ownership stake. Our contention is also consistent with the notion that relationships between individuals may have spillover effects that impact and, in turn, are impacted by other relationships (Emirbayer & Goodwin, 1994; Fukuyama, 1995; Granovetter, 1985). Consequently, beneficial relationships between any two parties may have positive impacts on other relationships and vice versa.

Furthermore, if the principal-agent relationship is conceived in terms of enlightened self-interest, individual goals may be difficult to decouple from the goals of others (or of the organization, for that matter). Related to this issue, Wilson (1993) has argued that individuals are predisposed to be affected by the welfare of others. Thus, if one is satisfied (or dissatisfied) as others are, selfish goals may have to be realized in the context of the goals of others. Selfish goals may also be subject to realization along with the goals of others because of the concept of duty—being faithful to one’s obligations to others. Being dutiful enhances one’s reputation, and in the process elicits the cooperation of others in one’s own endeavors to achieve personal goals (Wilson, 1993). Consequently, each person (e.g., agent, community member, employee, or supplier) may be better off via actions that also benefit others, including the principal (Donaldson, 1990; Emirbayer & Goodwin, 1994; Fukuyama, 1995).

In the case where agency theory’s assumptions are not relaxed, certain agents may, in fact,
be work averse. For these agents shirking may be preferred because agents can lower their disutility that are associated with the efforts invested in their specific work. On the other hand, for situational and dispositional reasons, working responsibly satisfies certain self-actualization needs (Maslow, 1943) or yearnings for achievement (McClelland, 1960). The next two propositions capture these divergent situations:

Proposition 1a: Some agents in some situations may not enjoy performing responsibly on the job. For these agents, shirking may be preferred because in this way they can lower their disutility associated with the efforts invested in their work. In this context, the assumption of goal conflict may be appropriate. Thus, the relationship between the principal and the agent may culminate in suboptimal outcomes.

Proposition 1b: Other agents, in other situations, may alternatively enjoy performing responsibly because of their personal needs for love, respect, and self-actualization associated with their employment. Under these circumstances, the assumption of goal conflict may be relaxed. Hence, the relationship between the principal and the agent may culminate in optimal outcomes.

As stated earlier, within the context of agency theory’s assumptions, certain agents may pursue selfish benefits at a cost to the principal. This usually takes place in the absence of rules and norms governing obligations and mutuality. Conversely, for a host of situational and dispositional reasons, enlightened self-interest and goal congruency may drive the principal-agent relationship. These contrasting situations are highlighted in the next two propositions:

Proposition 2a: In some situations, where there is an absence of norms of obligation and reciprocity, the agent’s pursuit of selfish benefits or perquisites may be disadvantageous to the principal because the benefits that accrue to the agent and others will be at the expense of the principal. In these situations, the assumption of goal conflict may be appropriate. Thus, the relationship between the principal and the agent may culminate in suboptimal outcomes.

Proposition 2b: In other situations, self-interest may be transformed into enlightened self-interest. As a consequence, the agent’s pursuit of benefits may by extension be advantageous to others as well as to the principal because of the social norms of obligation and reciprocity. Here, the aggregate goodwill generated in the context of the socially embedded enterprise may boost its prospects, enhancing the value of the principal’s ownership stake. Under these circumstances, the assumption of goal conflict may be relaxed. Hence, the relationship between the principal and the agent may culminate in optimal outcomes.

3.2. Risk preferences

Individuals are ordinarily assumed to be risk averse (Jemison, 1987; March & Shapira, 1987; Wright et al., 1996). In agency theory, however, this assumption is relaxed regarding the principal but not the agent. With respect to the principal, the assumption of risk averseness is relaxed in favor of an assumption of risk neutrality because principals pre-
sumably are able to diversify their investments. The assumption of risk averseness, however, is not relaxed with respect to the agent since agents cannot diversify their employment. Thus, at the individual level, another extension that may be made regarding agency theory is to relax the assumption of a risk-averse agent.

In our view, the relaxing of the assumption of a risk-averse agent may be appropriate in certain instances because a number of scholars have convincingly argued that individuals may significantly vary in their risk attitudes (Child, 1974; Eisenhardt, 1989; Hambrick & Mason, 1984; MacCrimmon & Wehrung, 1986). For example, some younger agents may not be risk averse according to the related literature: “what emerges is a picture of youthful managers attempting the novel, or the unprecedented, [which are proxies for] taking risks” (Hambrick & Mason, 1984, p. 198). As another example, other agents may not be risk averse because they may prefer to adopt the prospector strategy for the enterprise (Miles & Snow, 1978; Wright, Kroll, Pray & Lado, 1995). Moreover, depending on the particular situation confronted, agents may display different attitudes toward risk, consistent with the arguments in prospect theory (Kahneman & Tversky, 1979; March & Shapira, 1987). This theory, initially developed by Kahneman and Tversky (1979), is based on the premise that individuals are psychologically risk-averse in satisfactory situations but risk-prone in unsatisfactory situations. “When identical problems are framed in gains and subsequently changed to losses, individual choices shift from risk-aversion to risk-taking” (Wright et al., 1995, p. 144). Consequently, some agents in certain situations may not be risk averse and may, in fact, exhibit risk “loving” behavior (Wiseman & Gomez-Mejia, 1998, p. 133) where agents accept options where risk is not fully compensated (Asch & Quandt, 1990; Piron & Smith, 1995).

Wiseman and Gomez-Mejia (1998) have also challenged the agency-based views on several grounds. First, they state that risk remains an underdeveloped concept within agency theory. They are critical of the agency-based corporate governance models that assume agents to be risk averse or even risk neutral, as opposed to exhibiting risk-seeking behaviors. This is in contrast to a substantial body of research on risk taking or risk seeking behavior (Bowman, 1980; Bromiley, 1991; Fiegenbaum, 1990; Jegers, 1991; March & Shapira, 1987; Sinha, 1994; Tversky & Kahneman, 1981) that has challenged agency theory’s restrictive assumptions. Second, Wiseman and Gomez-Mejia (1998) suggest that a contingency-based perspective from behavioral research on risk taking (Bazerman, 1994; Kahneman & Tversky, 1979; March & Shapira, 1992) will allow for the possibility for varied risk preferences by the agent in a corporate governance setup. Third, Wiseman and Gomez-Mejia (1998) mention that despite considerable theoretical, analytical, and empirical support for a link between governance structure and agent risk choices, the nature of the precise relationship is far from clear. Finally, Wiseman and Gomez-Mejia (1998) state that an agent’s choices of risk may be affected and influenced by their prior success at selecting risky alternatives. Overall, there are reasonable grounds to question agency theory’s restrictive and, in deed, narrow assumptions that associate agents exclusively with risk averse behaviors.

The nature of the environment within which a principal-agent relationship exists may also impact the prevalence of distinct risk preferences. For instance, agents who are not risk-averse may be attracted to forming agency relationships in dynamic settings. That is because such agents may be willing and able to cope with the added unpredictability of the external environment (Tushman & O’Reilly, 1997). Similarly, principals may avoid risk-averse
agents in favor of risk-neutral (or risk-prone) agents when forming relationships in turbulent environments because, under these circumstances, risk-averse agents may be perceived as incapable of effectively dealing with new opportunities or threats associated with more dynamic settings. The preceding discussion implies that agents may not be universally risk averse under all conditions. Based on our reasoning as to why agents, under certain circumstances, may be risk seeking or risk loving, we submit the following propositions to address these divergent situations:

Proposition 3a: Some agents, under certain circumstances, may be risk averse. For these agents, risk-reducing strategies may be preferred because in this way they not only could lower their disutility associated with their work (e.g., anxieties associated with innovations) but also are able to reduce their prospects of losing their jobs. In this context, the assumption of a risk-averse agent may be appropriate. Thus, the relationship between the principal and the agent may culminate in suboptimal outcomes.

Proposition 3b: Other agents, in other situations, may not be risk averse. In this setting, the assumption of a risk-averse agent axiomatically may be relaxed. Hence, the relationship between the principal and the agent may culminate in optimal outcomes.

4. Focus on the group and organization

In the previous section, we discussed the proposition that agency costs accrue because it is assumed that the principal and the agent have different goal orientations as well as risk preferences. In this setting, the agent is not expected to behave responsibly. Thus, suboptimal outcomes may be associated with an agency relationship as the self-interest of the utility maximizing agent is presumed to be competitively related to the self-interest of the principal. Alternatively, by relaxing the agency theoretical assumptions, we argued that self-interests of other individuals in certain situations may be cooperatively related to each other. Under these circumstances, the agent may behave responsibly and optimal outcomes may be associated with an agency relationship.

In this section, we extend our examination of agency relationships to encompass the organization and its groups, granted that organizations are “legal fictions which serve as a nexus for a set of contracting relationships among individuals” (Jensen & Meckling, 1976, p. 484). Since viable organizations tend to grow (Penrose, 1959; Wright et al., 1996), we argue that given the agency theoretical presumption that the self-interests of individuals are competitively related to each other in their exchanges, the growth of an organization and its related groups may be expected to entail higher agency costs. Thereby, suboptimal outcomes may be anticipated for some organizations and their groups. This presumption may be relaxed, however, in favor of subscribing to the notion that the self-interests of other individuals in other circumstances may be cooperatively related to each other. Consequently, growth of other firms and their related groups may not entail higher agency conflict. Therefore, optimal outcomes may be anticipated for some organizations and their groups as they grow. We elaborate further in the following paragraphs.
Note that the agency relationship is primarily examined in the context of an individual principal or agent. Nevertheless, the generality of the agency problem that is relevant to the group or organization is recognized. According to Jensen and Meckling, agency "relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, and so forth" (1976, p. 484). Moreover, the agency relationship exists "at every level of management in firms" (Jensen & Meckling, 1976, p. 483). That is, to the extent that a manager of a firm "must obtain the cooperation of others in order to carry out his tasks . . . and to the extent that he cannot control their behavior . . . they will be able to appropriate . . . resources for their own ends" (Jensen & Meckling, 1976, p. 483).

Indeed, consistent with the arguments in team production (Alchian & Demsetz, 1972), Jensen and Meckling assert that "agency costs arise in any situation involving cooperative effort (such as the coauthoring of this paper) by two or more people . . ." (1976, p. 483). In our view, the implication of this assertion is that the larger the group becomes, the more potential for agency costs. That is because individuals are utility maximizers; thus, they are prone to consume perquisites. More important, however, they are predisposed to shirk (Alchian & Demsetz, 1972). By extension, it may also be argued that the more numerous the groups within an organization (i.e., as more horizontally or vertically situated cooperative groups are formed), the greater the potential for agency conflict. These contentions are compatible with the arguments in team production (Alchian & Demsetz, 1972) as well as Jensen and Meckling’s suggestion that "the larger the firm becomes the larger are the total agency costs . . ." (1976, p. 522).

To further elaborate, we emphasize that groups are contractually formed within an organization presumably because more can be produced by working together than separately. Thus, group members may have an incentive to behave somewhat responsibly in their cooperation with one another, particularly if a group is composed of fewer members. As the number of group members increases, however, the potential for shirking also rises because it becomes progressively more difficult to evaluate the contribution of each group member (Alchian & Demsetz, 1972). In this context, the disutility of exerting effort on the part of each member is hers alone, while the benefits that result from the effort expended is divided among the group membership. Because each team or group member is confronted with all the costs of any effort expended but denied from receiving all the credit associated with the effort, group production per member may decline as group membership expands. Similarly, perquisite consumption may increase as group membership grows. Thus, agency costs may be directly associated with group size.

Moreover, the organization may be "viewed as a team whose members act from self-interest but realize that their destinies depend to some extent on the survival of the team in its competition with other teams" (Fama, 1980, p. 289). More specifically, a firm may be conceived of as a team that consists of a set of horizontally or vertically related groups of actors who are confronted with competition vis-a-vis the related groups of other firms. Presumably, members of each group recognize that their employment, to a degree, depends on the viability of their own group as well as the firm's other related groups. That is because the outputs of the team or the firm are made possible by mutual efforts within and across the various related groups and only in this way could the firm attempt to deliver "the product
demanded by the customer at the lowest price while covering costs” (Fama & Jensen, 1983, p. 327).

As the number of groups within the firm rises, however, the potential for shirking again increases because it becomes progressively more complex to evaluate the contribution of each group to the final product, or to monitor individual members of the group. In this setting, the disutility of exerting effort on the part of each group is that group’s alone, while the benefits that result from the effort expended is split among the various related groups. Because each group is confronted with all the costs associated with the effort exerted but are denied from receiving all the rewards associated with the effort, production per group may decline as the number of related groups increase. Perquisite consumption may also expand as the number of groups increase. Hence, agency costs may also be positively associated with the number of related groups within a firm.

The preceding discussion, consistent with the premise of agency theory, is based on a behavioral model that is predicated on the utility-maximizing, economic person phenomenon. Put differently, in agency models individuals in the context of the group or firm level of analysis are presumed to have preferences for their own perquisite consumption and actions (or inaction due to shirking) which are not coaligned with those of others (Eisenhardt, 1989). Under these circumstances, it is anticipated that individuals in more complex, multilateral relationships will transmit negative sanctions to others because their self-interests are assumed to be competitively interrelated (Willer, 1981).

The assumption of utility maximizing behavior at the group or firm level of analysis, however, may be relaxed by resorting to a behavioral model that is predicated on the notion that enlightened self-interest may impact intra- or intergroup behavior. Moreover, a number of scholars contend that relationships between individuals may have spillover effects that impact and, in turn, are impacted by other relationships (Emirbayer & Goodwin, 1994; Fukuyama, 1995; Granovetter, 1985). Thus, it can be argued that the well being of each person may be difficult to decouple from the well being of others (Wilson, 1993), implying that within a group or organization individuals may be better off via actions which also benefit others. This implication is compatible with the notion that some individuals in select multilateral relationships are motivated to transmit positive sanctions to others because their self-interests are assumed to be cooperatively interrelated (Willer, 1981). This implication is also consistent with Ouchi’s (1979) conception of the clan type organization in which individual self-interests are cooperatively interrelated.

Our discussion so far indicates that based on the assumption that self-interests of individuals are competitively related to each other in their exchanges, agency costs rise as the size of the organization increases (i.e., as group membership and the number of related groups within the organization increase). If this agency theoretical assumption is relaxed in favor of an alternative one (that the self-interest of individuals may be cooperatively related to each other in their exchanges), however, an argument may be made that agency costs need not rise as the organization expands. Thus, we offer the following complementary propositions:

Proposition 4a: In some organizations, self-interests of individuals may be competitively related to each other in their exchanges. In other organizations, self-
interests of individuals may be cooperatively related to each other in their exchanges. Thus, agency costs may be directly associated with group size as well as the number of related groups within some organizations but not others.

Proposition 4b: In some organizations, where self-interests of individuals within and across groups are competitively related to each other, agency relationships may culminate in suboptimal outcomes. In other organizations, where self-interests of individuals within and across groups are cooperatively related to each other, agency relationships may culminate in optimal outcomes.

5. Concluding remarks

Agency costs inevitably accrue, if it is assumed per agency theory that the self-interest of individuals are competitively related to each other in their exchanges within a group or an organization. Consequently, to control agency costs, there is a need for a more specified formal contract in economic exchanges. Moreover, to verify that the conduct of individuals is compatible with their stipulated contracts, vigilant monitoring may be required. Additionally, because of the potential for adverse selection, bonding efforts on the part of individuals may be needed. In spite of contracting, monitoring, and bonding efforts, however, there will still remain “some divergence between the agent’s decisions and those decisions which would maximize the welfare of the principal” (Jensen & Meckling, 1976, p. 482). This remaining divergence is another component of agency costs and it represents the residual loss. Thus, given the assumption that self-interests of individuals are competitively related to each other in their exchanges within an organization, agency costs may rise as the organization grows (i.e., as group membership and the number of related groups within the organization increases). Higher agency costs will presumably have an adverse effect on the efficiency of the organization, culminating in suboptimal outcomes.

Alternatively, it may be argued that self-interests of individuals may not be universally competitive in their economic exchanges within an organization. Indeed, self-interests of individuals may be cooperatively interrelated within some organizations. Under these circumstances, contracting, monitoring, and bonding efforts could be minimized and the residual loss may be negligible. Thus, lower agency costs may prevail as some organizations grow. Lower agency costs presumably are positively associated with the efficiency of the organization, culminating in optimal outcomes.

5.1. Public policy implications

The problem of agency is central to the corporate governance debate literature (Arrow, 1971, Arrow, 1985, Fama, 1980, Fama & Jensen, 1983, Jensen & Meckling, 1976, Ross, 1973, Wright, Ferris, Sarin & Awasthi, 1996 among others). A tension supposedly exists between the objectives of shareholders (or the principals) versus the objectives of managers (or the agents). Contrast this with management’s stakeholder approach to corporate gover-
nance where an agent is constrained by many factors that include numerous stakeholders other than shareholders, and these constraining factors reduce agent latitude with respect to selfish behaviors as that agent has to pursue multiple and, sometimes, conflicting goals (Brenner & Cochran, 1991; Donaldson & Preston, 1995; Hart, 1995; King, 1995; Jones, 1995; Quinn & Jones, 1995; and Srivastava, 1995).

The debate and difference between agency theory and stakeholder theory has been contrasted so sharply that the two views are considered to be polar opposites (Shankman, 1999). Can these two opposing viewpoints be reconciled? One possible way suggested by Shankman (1999) is that agency theory should be expanded to include stakeholders, as well as to consider the moral actions of agents. There is increasing recognition, based on cognitive moral development theory, that ethical and moral considerations constrain economic behavior of individuals (Rutledge & Karim, 1999).

It is worth noting that the foci and intent of both paradigms, the economics and management paradigms, are presumably similar in that society’s resources should be efficiently allocated. At the societal level, both the economics and management paradigms have similar objectives in attempting to improve efficiency, optimize resource allocation, and increase savings. In effect, the two perspectives or paradigms attempt to achieve the same goals through different means.

From a public policy point of view, we do not believe that we can or even should attempt to integrate or reconcile these two perspectives. The two approaches are symptomatic of our fundamental attitudes and assumptions about the nature of people. The well-known theory of motivation (McGregor, 1960) would serve as a reasonable analogy to demonstrate how two perspectives and their related assumptions may differ significantly, but the final objective is the same, namely, how to enhance productivity. The lasting legacy of Douglas McGregor’s The Human Side of Enterprise and his Theory X and Y is that it shows that fundamentally different assumptions can be made about people. Theory X assumes that all workers are born lazy and are irresponsible, and must be constantly coerced into doing work and only come to work to collect their pay. Theory Y, on the other hand, suggests that workers are essentially creative and trustworthy, and will work autonomously and responsibly.

The two perspectives under discussion in this paper address two divergent viewpoints that we have about people. The economic view is that human beings are selfish and, if unsupervised, will act opportunistically with guile and deceit. In contrast, management theory is markedly different regarding assumptions about agents. Consistent with this view, Granovetter (1985, 1992) mentions that reality is considerably more complex, thus, both economic and social forces are combined in the making of decisions and consequent human actions. This allows both passions and interests to coexist such that social influences and rational choice are interconnected. In other words, economic action is embedded in complex social structures, and social embeddedness, in turn, shapes economic outcomes (Uzzi, 1996, 1997). Public policy is essentially guided by normative considerations. We argue that both the economic and management paradigms will coexist, and the primacy of one or the other as the appropriate paradigm, will depend on which viewpoint we believe most appropriately describes human nature and human relationships.
References


